

Plan to enhance existing local revenues and utilize opportunities for new local revenue

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Executive Summary

This document spells out the essential elements of a roadmap for the short, medium and long term to achieve revenue adequacy for the governorates of Iraq.

This is achieved in the very short term by transforming existing flows of federal government spending on budget-funded organizations into specific grants channeled through governorates, to be forwarded by them to the budget-funded organizations (§ 1). This issue is of the highest priority. Over time, specific grants can be replaced by other funding mechanisms, to allow for greater local autonomy.

Specific grants cannot finance the greater overhead costs of the governorates that result from decentralization: the need for policy making, administration, budget preparation and execution, procurement, and audit. At the federal level, the need for these overhead costs will be less. That creates a need for re-assignment of existing federal revenue sources. It should be possible to decide which revenue sources should be decentralized by 31 March 2016 (§ 2).

Related is the decision about the administration of the revenue sources to be decentralized. The decentralization of administration is less urgent, as presently MoF takes care of it. If that is to be continued, an MoU should be brought in place between MoF and the governorate, in which MoF gives guarantees for the timeliness of money transfers and for accountability, in exchange for a service fee (§ 3). If on the other hand administration will be transferred to the governorates, a plan should be agreed for the transfer of human, physical and organizational capital (§ 4).

Important issues for the long term include the following.

- The establishment of a permanent platform for dialogue on inter-governmental fiscal relationships (§ 5.1)
- A rationalization of the Chart of Accounts presently in use at all levels of government (§ 5.2)
- Finally, there is a local revenue policy reform agenda, requiring action at both the federal and the governorate level. The items with the highest priority are spelt out in § 5.3.

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Abbreviations

ARDP	Accelerated Reconstruction Development Program
GCT	General Commission for Taxes
GIS	Geographic Information System
MoF	Ministry of Finance
MoU	Memorandum of Understanding
PFM	Public Finance Management
PIT	Personal Income Tax
SoW	Scope of Work

Introduction

The Scope of Work specifies as the sixth deliverable a

“Detailed, sequenced, prioritized plan to enhance existing local revenues and utilize opportunities for new local revenue”

logically resulting from Task G specified as

“Recommend enhancement of the existing local revenues and opportunities for new local revenue based on best international practices, in the form of a detailed and relevant step-by-step roadmap to enable local governments to begin setting up revenue generation and collection procedures and systems.”

This should not be interpreted too narrowly. Important is the objective of revenue adequacy, for each function of each governorate. To guarantee that in the short term, it seems unavoidable that existing federal expenditures (for instance, from the federal health budget) are transformed into specific grants rechanneled through the governorates towards the same beneficiaries as before (in the chosen example: the health care institutions in the governorates). Such specific grants do not fall under “existing local revenues”, and fall under “new local revenue” only if this interpreted in a sense that is wide enough to cover revenues from external sources, i.e. fiscal transfer. Therefore “local revenue” is any revenue of LGs: not only own source revenue (also known as “internally generated revenue”), but also financial transfers received from the federal government, an external source. Similarly, the phrase “to begin setting up revenue generation and collection procedures and systems” should be interpreted as including arrangements with external revenue collectors, first of all the Ministry of Finance (MoF).

Such a plan will, logically, have the following five components.

- 1) Establishing, for the very short term, a scheme of specific grants, that replaces federal expenditures, and re-channels it through the governorates.
- 2) The decision which will be the revenue sources that are to be reassigned to the governorates.
- 3) The decision on which of the revenue sources to be reassigned to the governorates (referred to under 2) should be administered by the governorates in the short run.
- 4) For each of these revenue sources (referred to under 3): a plan for the transfer by MoF to the governorates of human capital, physical capital, and organizational capital. And complementary to that, a plan of the governorates to fill all the gaps that will not be covered by the transfers by MoF.
- 5) Matters to be addressed in the long term, such as
 - the establishment of a platform for permanent dialogue between the governorate and federal tiers of government on Public Financial Management (PFM);
 - a review of the revenue part of the Chart of Accounts;
 - the development of governorate-level policies, such as making fee rates cost covering, and the elimination of the existing nuisance taxes and “fees”.

These five components define the five chapters of this document.

1. Specific grants

It is highly improbable that the creation of new revenue sources will generate enough revenue for the huge responsibilities that are currently being decentralized – even if there were no start-up problems (like investment in equipment and training), and even if the new or enhanced revenue sources would be fully supported by the population of Iraq (which is unlikely, as many are financially struggling). The reasons are

- that the responsibilities to be decentralized such as health care and education are financially very important; in any country these account for some of the largest obligations of the government (in the budget of the Netherlands for 2015, they amounted to 28% and 13% of total spending respectively);
- that the potential of the own revenue sources to be reassigned or enhanced are too small; and
- that even general purpose grants (the petro dollars, and the ARDP funds to the extent they are not earmarked for the capital budget) are too small.

The sectors concerned (specified in article 45-1 of Law No. 21 of 2008, as amended in August 2013), including health care and education, are in grave peril if revenue adequacy is not guaranteed.

That leaves only one plausible option: specific grants, which are discussed in § 3.1 of Deliverable 7. It means that existing spending streams are continued, but rechanneled through the governorates. Instead of federal government transferring the money directly to the budget-funded organizations, they will transfer it to the governorate, and the governorate to the budget-funded organizations. That involves one step more. Therefore, timeliness of both transfers is essential.

MoF needs, for all decentralized functions, to collect information on planned expenditure per governorates, with specific details for the budget-funded organizations, and the timing of the transfers. MoF should share this information with all governorates.

Next, it should make transfers to the governorates in accordance with this spending plan. The governorates should forward the money to the budget-funded organizations in its jurisdiction. The budget-funded organizations should account for the way they spend this money in the usual way. However they should not send their reports to the federal line ministry that used to finance them, but to the governorate, which will forward the financial reports to federal government.

In this way, the governorates are still little more than just another link in the chain, and they enjoy still very little autonomy. However the most important objective is to avoid that any budget-funded organizations are bled dry due to governorates not having adequate financial resources.

It is only over time that governorate autonomy will grow, by taking over powers and responsibilities with respect to policy making and implementation, budget preparation and execution, procurement and audit from the federal level. Those subjects themselves are beyond the scope of this document.

It is impossible that those additional responsibilities can be funded by specific grants. Decentralization creates the need for a new or enhanced tier of government at a lower level, and simultaneously reduces the need for government services at a higher level. Therefore there is a need for additional revenue generation, through sources that are either already existing (at either the federal or the governorate level), or new. That will be the subject of the remaining sections of this document.

It is well-known that specific grants do not allow a great role for LG autonomy. Federal government may decide, for that reason, to adopt a policy for the medium and long term of gradual replacement (substitution) of specific grants by other revenue sources, such as

- General Purpose Grants (§ 3.2 of Deliverable 7);

- revenue sharing (Chapter 2 of Deliverable 7), or
 - assignment of revenue sources to LGs (Chapter 4 of Deliverable 7).
- That is the other justification for the remaining sections of the present document.

Summary. In the short term, specific grants to governorates should re-channel existing expenditure streams through the governorates towards the budget-funded organizations. This is essential for the sake of revenue adequacy of the budget-funded organizations.

2. Decision on revenue reassignment

The decision on revenue assignment (see Deliverable 4) is the decision on which most of the remaining steps depend, and therefore comes next in sequence and in importance.

In this formulation, “the remaining steps” include the matters covered by sections 3 (revenue administration) and 4 (human, physical and organizational capital) of this document, whereas the phrase “...most of...” is there because of the following exceptions, which cannot be implemented soon.

- The constitutional reforms (see chapter 1 of Deliverable 1).
- The reform of Law No. 130 from 1963 on the Revenue of Municipalities (see chapter 3 of Deliverable 1).
- To some extent the reform of the system of transfers (see Deliverable 3). Some of the reforms recommended there can proceed; others should wait for better conditions (with respect to oil price and insurgency). The recommendation to apply the equalization principle to the Accelerated Reconstruction Development Program (ARDP) funds will require estimating the revenue potential of specific revenue sources, which will depend on the assignment of revenue sources to the governorates.

The decision on revenue assignment is to be taken soonest, by MoF, after having consulted the governorates, and taking into account the recommendations of Deliverable 4, in particular the conclusion of § 3.3 of that document:

Conclusion of § 3.3 of Deliverable 4. Revenue sources that must be considered when reassigning revenue sources to Iraq’s governorates include personal income tax (on the basis of revenue sharing), the taxes on property and land, the tax on the tourism services of hotels, property transfer tax, the vehicle transfer tax, vehicle registration fees (on the basis of revenue sharing), and the *maks*es.

When consulted, the governorates should put forward as arguments

- 1) that the decentralization process gave them additional responsibilities for policy and administration, and
- 2) that the reassignment of the revenue sources concerned would be in line with international standards.

The first argument requires, in principle, three sets of quantitative estimates per governorate.

- First, estimates of the costs of the recently devolved responsibilities. The governorates should request that the MoF provide this information, in line with article 45-1-1 (introduced in August 2013) of Law No. 21 of 2008 which requires a “...transfer of sub-directorates, departments, tasks, services and competencies executed by Ministries ... *along with their funds allocated by the General Budget*”. This requires the quantification that is also required by the transformation of these financial flows into specific grants as referred to in section 1 above.
- Second, estimates of the costs of the additional overhead costs of policy making and

administration. These may be proportional to the specific grants.

- Third, actual figures for revenue generated per revenue source.

In this way long-term revenue adequacy could be assessed with some rigor. For 2016 it is expected that ARDP funds will be greatly reduced by 59%, so that in the short term the governorates need substantial compensation. Even for the long term, after ARDP funds will be fully restored, it is plausible that all revenue sources recommended in Deliverable 4 need to be reassigned. This is so due to the expected (based on the very limited information available) modest size of the revenue sources to be reassigned. For instance, Personal Income Tax (PIT) amounted to 27.1% of all federal tax revenue in 2010, but only 9.4% in 2009; and federal tax revenue amounted to only 5.8% of total federal revenue in 2015. Therefore it would be reasonable that (instead of revenue sharing) all of PIT would be reassigned to the governorates. In The Netherlands, the reassignment of government responsibilities from the national to the local level often is not accompanied by adequate additional funding for the municipalities, so that with respect to funding, decentralization often boils down to a cost cutting exercise.

Recommendation. After the establishment of a comprehensive system of specific grants, federal government must decide, based on a quantification of revenue and spending of each governorate, which revenue sources must be reassigned.

3. Decision on revenue sources to be administered by governorates in the short term

Third, federal government must decide which of the revenue sources to be reassigned to the governorates should be administered by the governorates in the short term (say before 31 December 2016). This decision too should be taken by the MoF in dialogue with the governorates. The timing of this decision should be quickly after, or even simultaneously with the decision on the money itself (§ 2, above). Generally speaking, because the MoF is already administering the revenue sources, the handover of administration itself is not extremely urgent.

However for revenue sources that will continue to be administered by MoF in the short term, a Memorandum of Understanding (MoU) should be drafted and signed, similar to an MoU for revenue sharing (Chapter 2 of Deliverable 7). The provisions of the MoU should guarantee:

- transfers with regular frequency (e.g. monthly), at a predictable time (e.g. the 21st of the month),
- accountability (a written explanation of each of the amounts transferred, in terms of registered payers, development of the tax base, etc.; furthermore a statement by an external auditor), and
- a sanction on delays in transferring in the form of a liquidity charge (statutory interest), with a definition of the rate (for instance linked to the refinancing rate or repo rate of the national bank of Iraq), the frequency of its application (daily or monthly), and the point in time from which it will apply.

The MoF is likely to require a service charge for its collection efforts. The rate of this service charge (as a percentage of revenue collected) should be based on the MoF's actual costs of collection. However it is likely that the MoF does not possess this information itself, because its Chart of Accounts does not distinguish cost centers, and even figures for the whole revenue collecting units at governorates would not be detailed enough. In any case the rate is to be negotiated, but it should not be excessive (3% rather than 10% of actual collections).

Less urgently, the MoF and the governorates should seek a common understanding about the

arrangement desired for these revenue sources in the long term. It may be that they will continue to be administered by federal government permanently (as is the situation with respect to Personal Income Tax in many countries), or that they draft a joint plan for the gradual transfer of administration to the governorates over a number of years (this happened in Jordan with respect to property tax, whose administration was transferred to the municipalities).

Recommendation. After deciding which revenue sources must be reassigned to governorates, federal government should decide which of those revenue sources need to be administered at governorate level in the short term.

For those revenue sources that continue, in the short term, to be administered at the federal level, an MoU should be put in place between General Commission for Taxes and the governorates.

4. Planning for human, physical and organizational capital

For each of those revenue sources whose administration should be transferred to governorates, there should be a negotiated plan for the transfer, between MoF's General Commission for Taxes and the Revenue Departments of the governorates, of

- human resources (staff, skills);
- physical capital (offices, furniture, office equipment, transport equipment; asset registers; hardware, software, databases; with respect to PIT and property tax, records of tax debts and cases under litigation; assessments of property that will be relied upon in future years); and
- organizational capital (reflected in organization structure, systems, approach to performance management, practices, routines, manuals, and organization culture).

The main benefit for MoF staff is their continued employment.

The whole government sector will avoid the waste of selling assets in the second market for low prices, while having to purchase similar assets new, and the waste of losing information on tax debts and appeals. Some of the assets are so specific to government needs that they are close to useless for other users. In principle the assets should be transferred for free, assuming that the governorates have little purchasing power. Scenarios can be envisaged where governorates will rent one or a few room(s) in premises owned by MoF's General Commission for Taxes.

For the governorates the transfer of these tangible and intangible assets is important to make a flying start, and avoid the hassle of recruiting and selecting inexperienced staff.

The plan should contain specific time frames.

Recommendation. With respect to the decentralization of the administration of revenue sources, a plan should be made for the transfer of human, physical and organizational capital.

5. Long term issues

5.1 Permanent platform for dialogue on inter-governmental fiscal relationships

In any country in the world, it is important to have a permanent communication channel in place through which national and local government can express their concerns. National governments typically are concerned about perceived local incompetence and waste, and wish to give local governments incentives to generate more own source revenue instead of being financially dependent and pressing for more financial support. Local governments, on the other hand, are typically concerned about national government transferring responsibilities without adequate finances (“unfunded mandates”) under the pretense of decentralization, and showing lack of interest and competence with respect to intergovernmental financial relationships.

This subject is elaborated in § 1.3 of Deliverable 7.

5.2 The revenue part of the Chart of Accounts (CoA)

Constitution article 122-2 guarantees governorates

“broad administrative and financial authorities to enable them to manage their affairs in accordance with the principle of decentralized administration, and this shall be regulated by law”.

Although the law called for does not yet exist, it is obvious that governorates should have autonomy to adopt their own Chart of Accounts to deal with the above inadequacies. That may, however, harm comparability of revenue statistics with the revenues of other governorates. Logically the following problems are to be addressed after, not before, the reassignment of revenue sources accompanying decentralization.

General comments to the revenue part of the federal CoA

- While the existing Chart of Accounts (CoA) was made for the accounting needs of the federal government, the following discussion focuses on the needs of sub-national governments alone. An important difference is that, whereas sub-national tiers of government do receive transfers (ARDP funds, petrodollars, possibly still others like transfers earmarked for specific purposes) from the federal government, the federal government itself does not. Chapter VII of the present (federal) CoA has codes only for grants received from foreign governments and international organizations. Therefore there is a need for extra categories, to account for all categories of grants received.
- For any category of revenue, there are no sub-categories for a) payments of revenue for previous years (paid late) and for future years (paid in advance); b) penalties related to late payment or non-payment of revenue; c) a liquidity charge for late payment of revenue.
- It is to be kept in mind that capital receipts (like the receipt of a loan, or the recovery of a loan, or receipt of revenue on behalf of other jurisdictions) are not revenue receipts, but are part of receipts nevertheless, and those codes are required to account for them.
- A few times the word دولة *dawlah* “state” is used, which cannot apply to sub-national governments. That concerns codes 1 04 02 04 رسوم في دوائر الدولة الاخرى, 1 08 01 إيرادات ايجار, إمتلك الدولة, and 1 08 02 10 07 الجريدة الرسمية للدولة.
- It is clear that there overlaps between Chapters VII and VIII, and all the other Chapters. Because the revenue part of the CoA has 395 items, these will not be discussed exhaustively.

Chapter II Taxes on income and wealth

No comments.

Chapter III Taxes on commodities and production fees

- The last words “...and production fees” of the title of this Chapter are remarkable, as fees are different from taxes. Apparently the production fees are to cover the makses, but these are taxes, and that is acknowledged by putting the makses under header 1 03 03 “taxes on production”. A maks is like a road toll, or like an excise. So the phrase “...and production fees” should be removed.
- A category for “other taxes” should be added. Presently there is no category here that will suit Iraq’s real property transfer tax. The CoA regards this tax as a fee (1 04 03 04), which it is not.

Chapter IV Fees

A few “fees” are probably taxes, like the “fees for the registration of real estate” (1 04 03 04, isn’t this property transfer tax?), the “fees” for the registration and transfer of ownership of means of transport (1 04 04), and the import “fees” on pharmaceuticals (1 04 05 03).

At the end there is a category for “other fees” (1 04 08 09), a good thing. Yet there are many more fees in Chapter VIII (1 08 02).

Municipalities will or may, in the future, need codes for garbage collection fees, sewerage fees, zoning fees, encroachment fees, parking fees, and market fees.

Chapter V Budget share of public sector profits

These are dividends from State-Owned Enterprises (SOEs). That is capital income, and therefore similar to the interest revenue which is in Chapter VII, and the rent revenue that is in Chapter VIII.

A long and rigid list is given of the present SOEs. It is remarkable that there is no code for other dividends, i.e. private sector companies in which the government has only a minority share. A code must be available for such dividends. It is not uncommon that sub-national governments (Jordan, the Netherlands) possess shares in public utilities, but such companies are not listed here.

Chapter VI “Capital revenue”

The name of this category suggests that it will cover dividends (Chapter V), interest (1 07 04), and rent (1 08 01), which it does not; these three are in three different chapters. Therefore the name is misleading, the chapter would better have been called “Sales of capital assets”. That is a non-recurrent source of receipts, and therefore the whole chapter should have been placed after all the other categories (Chapters VII and VIII).

The classification is excessively detailed; that is not a real problem. But it is not detailed at all for the probably most important category, namely land. For this category, new sub-categories may have to be created in the future, namely

- land ready for construction, sold for residential purposes, vs.
- land ready for construction, sold for commercial/industrial purposes, vs.
- unimproved land, vs.
- land expropriated and auctioned for non-compliance with property tax.

Chapter VII “Transformation revenues”

This is an extremely heterogeneous category. It includes foreign exchange rate gains, insurance benefits, refunds, interest (which is capital income), grants, sales of produce (whereas sales of equipment fall under Chapter VIII, and sales of capital assets under Chapter VI), donations, and social security premiums. The concept of “transformation revenue” is internationally unknown, it serves no understandable purpose, and therefore ought, in due

time, to be replaced in line with the International Monetary Fund (IMF) in its *Government Financial Statistics Manual* (latest edition: 2014)¹ (GFS).

In this Chapter, codes 1 07 05 and 1 07 06 limit grants to those coming from foreign governments, international organizations, and civil society organizations. That does not exhaust all possible scenarios. For instance, in Jordan the capital ʿAmmān sometimes makes grants to neighboring municipalities to enable them to deal with problems they have in common.

Chapter VIII Other income

This chapter is as heterogeneous as the previous one. It comprises the following categories.

- Rent (1 08 01), which ought to be part of property income along with dividends and interest.
- Many fees again (1 08 02), while Chapter IV also concerns fees, and several categories do definitely overlap. The use of the word أجور *udjūr* “compensations, payments, charges” instead of رسوم *rusūm* (the word used in Chapter 4) is meaningless.
- Fines (1 08 02 08).
- Sales of current assets (1 08 02 10), at least if these are not own products (1 07 07), and to be distinguished from capital assets (Chapter VI).

Recommendation. Governorates should strive to achieve consensus among themselves to bring the Chart of Accounts in line with international standards:

- add codes for transfers from federal government, for payments for previous and future years, for late payment penalties and liquidity charge, and for other missing categories;
- eliminate duplications;
- separate non-recurrent receipts from recurrent revenue;
- treat dividends, interest and rent identically;
- and replace the word دولة *dawlah* “state” by محافظة *muḥāfaẓah* “governorate”.

5.3 Revenue policy

There is a continuous need for revenue policy making at both the federal and local levels. In addition to the matters already brought up in Deliverables 1, 3 and 4, the following issues should presently rank high on the local revenue policy agenda.

- At the national level, there is a need for a review of the legislation on property tax and property transfer tax.
- As mentioned in Deliverable 3, the distribution of the ARDP funds should, at least to some extent, reflect the equalization principle. Therefore its formula should be revised.
- At the governorate level, it is necessary to eliminate nuisance taxes and nuisance “fees”, that hardly generate revenue but waste the time of citizens and governorate officers alike, or that are discriminating or a burden on vulnerable groups of citizens, and thereby unfair.
- Also some governorates should revise their policy of “sugarcoating” taxes by calling them “fees” although no services are provided, or fee rates are far in excess of costs.
- Governorates should make fee rates cost covering by researching the costs of the associated services.

¹ www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf, page 88.